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SUBJECT: U.S. OIL COMPANIES ON INVESTMENT OPPORTUNITIES IN BRAZIL

Sensitive But Unclassified. Please handle accordingly.

¶1. (SBU) Summary: The US Commercial Service in Rio organized an oil roundtable discussion with US oil companies and Ambassador Sobel on January 8, 2008. The CEOs of Chevron, Exxon Mobil, Devon Energy, Anadarko, and Hess Corporation briefed Ambassador Sobel on the investment climate for foreign players in Brazil, prospects for future oil discoveries, and shared their views on the oil and gas regulatory and fiscal regimes. The participants believed the overall investment climate was positive for US companies but obstacles included instability in the oil auctions and in the tax and licensing regimes. The Ambassador offered to advocate on behalf of the participants with GOB officials and with the National Petroleum Agency (ANP). The companies welcomed this idea and suggested emphasizing the need for stability to encourage investment. The Ambassador also proposed that the Brazilian Petroleum Institute (IBP) meet with relevant foreign ambassadors in Brazil to discuss overall concerns. End of Summary.

¶2. (U) Ambassador Sobel met with executives from US oil companies operating in Brazil on January 8 in a roundtable organized by the US Commercial Service in Rio and hosted by American Chamber of Commerce President Joao Cesar Lima. Participants included Anadarko President Kurt McCaslin; Chevron Brasil President Daniel Rocha and Business Development and Government Relations Director Patricia Pradal; Devon Energy President Murilo Marroquim; Exxon Mobil (Esso) President John Knapp; and Hess Brasil Exploration Coordinator Paul Gomes and Negotiations and Business Manager Joseph Wesley.

Brazil's Oil and Gas Potential

¶3. (SBU) Ambassador Sobel asked the participants for an overall description of the investment climate for US companies in Brazil. Expressing the view of all present, John Knapp, President of Exxon Mobil, confirmed that Exxon had a great deal of interest in Brazil because of perceived substantial undiscovered potential beyond even the Tupi field that Petrobras recently discovered. However, he expressed concern about the recent unstable investment environment caused by Rio State tax changes, oil blocks being removed in the last two auctions, and the Government of Brazil's (GOB) apparent willingness to change the oil concession contracts. He indicated that companies might begin to reassess the economic benefits of investing if there were continued instability.

Changes in Oil Auctions

¶4. (SBU) Responding to Ambassador Sobel's question on whether the oil blocks removed from the recent 9th oil licensing round would be made available for an upcoming auction, Knapp said that the GOB had not yet made a decision. One of the justifications alleged by the GOB for having removed those blocks was based on Petrobras'

statement that the Tupi oilfield discovery brought a new exploration niche for Brazil, thus reducing the exploration risk to find oil, with which Knapp did not agree. In his opinion, exploring under-salt areas presented significant geological and technical challenges. Devon Energy's President Murilo Marroquim added that Petrobras had lied about the easy prospects of finding oil in under-salt areas due to the Tupi discovery. He believed Petrobras influenced the GOB to remove the blocks from the 9th oil auction to avoid stiff competition with other bidders. Devon asserted that Petrobras did not have sufficient drilling equipment so had an interest in removing those blocks to allow more preparation time for it to bid for those blocks in future auctions.

¶5. (SBU) Knapp believed that the GOB might reconsider the current oil auction model that is based on signature bonuses. Marroquim from Devon did not seem so sure about drastic changes, and added that if substantial modifications to the current oil law were proposed, the Brazilian Congress would need to approve them, which might take a long time. Marroquim believed that the GOB might not want to take this route as it may have an unpredictable outcome. For example, he and others cited the new proposed gas bill that has been in Congress for at least four years. Petrobras has been advocating to protect its interests in gas infrastructure, but several amendments have been made to the gas bill that may, in the end, not favor Petrobras. (Note: In a recent interview to the Folha de Sao Paulo newspaper, Petrobras President Gabrielli cleared defended changes in future oil auctions. He views oil production sharing or service rendering contracts, where an oil company operates an oilfield and is financially compensated for that while the State keeps the oil field ownership, as better contract alternatives for Brazil.)

Advocacy through IBP

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¶6. (SBU) Ambassador Sobel suggested that the US companies engage other foreign Chambers of Commerce in Brazil to advocate for their interests. Marroquim assured the Ambassador that they already work through the Brazilian Petroleum Institute (IBP) and noted that generally when politically sensitive topics were discussed at IBP meetings, Petrobras officials tended not to participate as actively.

Ambassador Sobel also suggested that the IBP organize a meeting with foreign Ambassadors in Brazil to have an open dialogue about the sector's issues. Chevron Business Development and Government Relations Director Patricia Pradal, who sits on the IBP Steering Group, expressed an interest in coordinating such a roundtable. Additionally, Rio American Chamber of Commerce (AmCham) President Joco Lima mentioned that some state governors seemed interested in a roundtable with the AmChams, which Ambassador Sobel found interesting due to the political clout it may give to the oil industry.

¶7. (SBU) Marroquim further commented that in December 2007, right after the 9th oil auction, the IBP met with the National Oil Regulatory Agency (ANP) to voice the oil industry's concern about possible changes in the oil law. The ANP General Director reportedly told IBP that the GOB might want to review current oil royalty and special participation fee levels. (Note: The latter refers to payment due on oil and natural gas exploration and production in the case of high volume or high profit margin fields. The basis for calculating the special participation fees is net revenue from quarterly production from each field after the legally permitted deductions. The percentage rates vary from 10 to 40%.) If these fee changes are made, IBP believes there will be no need to pass them by Congress. Anadarko's President Kurt McCaslin said that oil royalties were in place in the Gulf of Mexico, but special participation fees were not. McCaslin emphasized that indirect taxes in Brazil, in general, were a burden for foreign investors.

Partnership with Petrobras

¶8. (SBU) All US companies present at the oil roundtable confirmed that they are partnered with Petrobras in some capacity. For

example, Devon holds nine oil concessions in Brazil, three of which are in partnership with Petrobras. Anadarko is partnered with Petrobras in four out of ten oil concessions. Chevron is currently developing the Frade oil field with Petrobras. Hess has one block in partnership with Petrobras and Exxon, the latter as the field operator.

¶9. (SBU) McCaslin stressed that Petrobras owned oil and gas infrastructure in Brazil, but being a partner with Petrobras did not mean one would have automatic access to the facilities. Marroquim stated that if one produced natural gas, it had to sell to Petrobras. On the other hand, oil offshore production did not depend as much on Petrobras' infrastructure, making exports from Brazil an easy process. Knapp explained that it was strictly a business decision if a company wanted to work with Petrobras. Sometimes it made more sense to work independently. In this regard, Brazil could be considered an open oil market. "More and more companies now have acreage where Petrobras is not a partner." A good example of companies not partnered with Petrobras was the case of new oil player OGX, owned by a large Brazilian mining company EBX and investor Eike Batista. In the most recent oil round, OGX presented the highest bids for seven blocks with strong potential in the offshore Campos basin. OGX spent more than 1.4 billion reais (US\$754 million), which was more than 70% of the total for the entire round. Batista was able to attract a team of former Petrobras officials to work at OGX, including Francisco Gros, ex-President of Petrobras; Paulo Mendonga, ex-Executive Manager of E&P of Petrobras; and Luis Reis, ex-Petrobras Contract Manager.

GOB to Limit Oil Exports from Brazil?

¶10. (SBU) Another regulatory risk cited in the roundtable was that the GOB might restrict oil exports if Petrobras delayed domestic (e.g. Tupi) oil production. The Brazilian oil law allows for this possibility in case of oil shortage and energy security interests. McCaslin worried that oil shortages caused by delayed production might lead to instability in government and a subsequent change in oil laws requiring foreign companies to sell to Petrobras. Hess Corporation Oil Exploration Coordinator Paulo Otvio Gomes did not foresee any technological barriers that would inhibit Petrobras developing the Tupi field. Gomes cited Petrobras' advanced technological research center as an important tool to give all the technological support Petrobras would need. He himself led a key Petrobras' project when he worked there aimed at the geological evaluation of the under-salt section of the Santos Basin, including the Tupi and "Sugar Loaf" deepwater areas between 1999 and 2001. Gomes believed there were further discoveries adjacent to Tupi. He hoped these fields would be offered in a competitive auction so Hess

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could participate.

Brazil's Gas Needs

¶11. (SBU) The participants agreed that Petrobras and Venezuela's government oil company PDVSA joint projects were aimed at increasing Brazil's heavy oil refining capacity, but Marroquim did not believe that the planned mega gas pipeline from Venezuela to Brazil would materialize since Petrobras is bringing liquefied natural gas (LNG) plants to Brazil instead. None of the US oil companies are partnered with Petrobras in this new LNG business in Brazil. In Marroquim's opinion, Brazil was being forced to invest in Bolivia to produce more gas. There is pressure for Petrobras to supply enough gas to fire the natural gas power plants because of low hydropower reservoir levels and possible power shortages. (Note: Although Petrobras owns the majority of domestic gas-fired power plants, a predominant share of Brazil's energy comes from hydropower (81.2%)).

Taxation Problems

¶12. (SBU) When asked about the status of changes to Rio State's VAT ("ICMS") tax on oil equipment, Patricia Pradal from Chevron provided

a quick background on the temporary admission regime (REPETRO) that the Federal government created in 1999. REPETRO exempted from federal taxes the importation of some of the equipment used by the oil and gas exploration and production industry. Since then, some states, particularly Rio, have made some changes that increased the states' VAT tax. (Note: About 85% of the oil produced in Brazil comes from the state of Rio. However, the VAT tax on the oil produced goes to the states where the oil is refined, mainly Sao Paulo which has four refineries. This has created a feeling of inequity.) Pradal said that the most recent development to the VAT tax was a counter-proposal made by IBP where Rio State would tax 5% with future credits, or, alternatively, 2% without credit. The Rio State Finance Secretary Joaquim Levy is considering a 3 to 7% alternative.

¶13. (SBU) The participants welcomed Ambassador Sobel's advocacy offer with Levy and suggested that the Ambassador convey to him a message on the need for tax stability. As the oil industry's high investments are only recovered long-term, it was crucial that they invest under a stable tax regime.

Licensing Complaints

¶14. (SBU) When the Ambassador asked how relations were with Brazil's environmental licensing organization IBAMA, several participants lamented the wait time on approvals and suggested that IBAMA's personnel could benefit from training offered by other countries, as Pradal noted USG officials had done before. McCaslin said, "It does not matter when you need the permit, they will approve it two weeks before."

Advocacy through Upcoming USG Visitors

¶15. (SBU) Ambassador Sobel cited the upcoming visits to Brazil of Energy Secretary Bodman and other VIPs as opportunities to engage GOB officials on areas of concern. He also welcomed talking points for his upcoming meeting with ANP and suggested another oil roundtable with Secretary Bodman during his visit. (Note: CS Rio has scheduled a meeting with ANP for February 15.) Regarding the meeting with ANP, Gomes added that conveying the importance of having a 10th round in 2008 would be appreciated.

¶16. (SBU) Chevron President Daniel Rocha noted that he was impressed with ANP's efficiency during the 9th oil auction and he hoped that ANP would preserve that system as it was a cornerstone for oil investment in Brazil. He added that the ANP had strong credibility and a good reputation for respecting contract sanctity. Rocha further stated that as Petrobras had recently been able to win a lion's share of blocks in the Gulf of Mexico, ANP should see that Brazil continued to benefit from foreign investment.

Comment

¶17. (SBU) Although our interlocutors complained of Brazil's somewhat inadequate climate for foreign investment due to tax instability, possible regulatory framework changes, and Petrobras' dominance and influence over regulatory issues, all oil roundtable participants seemed interested in remaining in Brazil due to good geological prospects to find oil and gas, and a more reliable investment and business environment than many other countries. A

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new Brazilian Minister of Mines and Energy recently assumed office. He will be faced primarily with ways to avoid power shortage in 2008 and 2009. Some directors at Petrobras are also expected to change due to political pressure from opposition parties. It remains to be seen how these changes may impact Brazil's oil sector, especially regarding future oil auctions.

This cable has been cleared with Embassy Brasilia.

MARTINEZ